

A. HEALTH CARE ORGANIZATIONS UNDER IRC 501(c)(3)

1. Introduction

This section updates the 1980 EOATRI and discusses the following current issues in the health care area.

- Medical Office Buildings
- Faculty Group Practice Organizations
- Home Health Agencies
- Professional Standards Review Organizations (PRSOs)
- Cooperative Hospital Service Organizations
- Shared Services

2. Medical Office Buildings

a. Introduction

The National Office has recently had to address the issue of the effect on the tax exempt status under IRC 501(c)(3) of the hospitals that are involved, in one form or another, in the construction of medical office buildings. The volume of cases and requests for information in this area indicate that this is a widespread activity.

b. Service Position regarding Hospital leasing of office space to physicians

It is a long-standing Service position that leasing by a hospital of office space to a related group of physicians in a building in close physical proximity to the hospital contributes importantly to the hospital's operation and is therefore substantially related to the performance of hospital functions. This position was established in Rev. Ruls. 69-463, 1969-2 C.B. 131, and 69-464, 1969-2 C.B. 132. These revenue rulings are reproduced below.

Section 513.--Unrelated Trade or Business

26 CFR 1.513-1: Definition of unrelated trade or business.

(Also Section 501; 1.501(c)(3)-1.)

The leasing of its adjacent office building, and the furnishing of certain office services, by an exempt hospital to a hospital-based medical group is not unrelated trade or business under section 513 of the Code.

Rev. Rul. 69-463

A community hospital exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 has asked whether the leasing arrangements described below constitute unrelated trade or business under section 513 of the Code.

The hospital has a medical staff of over 150 physicians and surgeons who have the privilege of admitting and treating patients in the hospital. However, in order to improve the hospital's ability to deliver a full range of health services to the community, the board of trustees decided to enter into negotiations with a medical group to induce them to carry on their professional activities on the hospital premises.

The medical group consists of 25 physicians and surgeons who, as their principal professional activity and as a group responsibility, are engaged in the coordinated practice of medicine in a common facility. The group is composed of a variety of medical specialists, including radiologists, pathologists, anesthesiologists, and internists.

As a result of arm's length negotiations, the hospital leased its adjacent office building to the group. The group uses the facility to provide medical services for its private patients. In addition, under the terms of the contract the various specialists within the group are also responsible for providing all diagnostic and therapeutic procedures, such as anesthesiology and radiology, to all hospital patients. The contract also requires that the group operate the hospital's emergency room on a 24-hour basis.

Because of its physical proximity to the hospital, the group is able to serve the outpatient needs of persons seeking medical services from the hospital on an ambulatory basis. In this way, the medical group also functions as the outpatient department of the hospital. The hospital maintains all medical records of the group as part of its central record keeping system.

Under the terms of the contract, the hospital provides the group with the nursing, secretarial, billing, collection, and record keeping services needed to carry on its medical practice. In consideration for the office space and services provided, the group is required to pay the hospital a fixed percentage of its gross billings for services rendered to both hospital and private patients.

The hospital has established that the presence of the group practice at the hospital has had the effect of (1) reducing hospital admissions, days of stay, and surgical rates; (2) permitting more efficient use of existing facilities; (3) making more effective use of scarce health manpower; (4) fulfilling the hospital's role as the health center of the community; (5) fixing administrative responsibility in a single group; and (6) making more effective use of hospital facilities for training purposes.

Section 513 of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the purpose or function constituting the basis for its exemption under section 501.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is "substantially related" to exempt purposes when the business activity has a substantial causal relationship to the achievement of the exempt purposes.

Section 1.514(b)-1(c)(1) of the regulations indicates, by example, that where a tax-exempt hospital leases real property owned by it to an association of doctors for use as a clinic, the rents derived under such lease would not be included in computing unrelated

business taxable income if the clinic is substantially related to the carrying on of hospital functions.

A lease by a hospital of part of the hospital to a doctors' association to use as a clinic is generally considered a trade or business related to the carrying on of hospital functions. See S. Rep. No. 2375, 81st Cong., 2nd Sess., C.B. 1950-2, 483 at 507. One definition of the term "clinic" is "a group practice in which several physicians work cooperatively." (Webster's Seventh New Collegiate Dictionary, 1967.) It is held that the group practice described above contributes importantly to the hospital's operations and is therefore substantially related to the carrying on of hospital functions. Accordingly, the leasing activity described above is not unrelated trade or business under section 513 of the Code.

26 CFR 1.513-1: Definition of unrelated trade or business.

The publication and continuing sale of a book having no substantial causal relationship to the achievement of an exempt purpose. See Rev. Rul. 69-430, page 129.

Section 514.--Business Leases

*26 CFR 1.514(b)-1: Definition of business lease.
(Also Section 501; 1.501(c)(3)-1.)*

Leases of office space by an exempt hospital to members of its medical staff who contribute importantly to the performance of hospital functions are not considered business leases within the meaning of section 514 of the Code.

Rev. Rul. 69-464

Advice has been requested whether the leases described below are excepted from the definition of the term "business lease" in section 514(b) of the Internal Revenue Code of 1954 by the provisions of section 514(b)(3)(A)(i) of the Code.

A community hospital exempt from Federal income tax under section 501(c)(3) of the Code built an adjacent office building for doctors in order to encourage members of its medical staff to maintain their private medical practices near the hospital. The building is subject to a mortgage incurred at the time of its construction. The hospital leases office space in the building to doctors to carry on their private medical practices. Only members of the hospital's active or courtesy medical staff may lease space, with active staff members given preference. Doctors who do not have staff privileges in the hospital are not accepted as tenants. The usual term of the leases, including options to renew, is for more than five years. However, the lease may be terminated sooner by the hospital in the event that a tenant ceases to be a member of the medical staff. Only janitorial and maintenance services are provided to the tenants by the hospital.

The hospital has established that (1) as a result of having members of its medical staff practicing medicine in offices adjacent to the hospital, greater use is made of the hospital's diagnostic facilities and patient admissions are easier, and (2) the physical presence of the members of the medical staff on the hospital's grounds makes the services of these doctors more readily available for outpatient and inpatient emergencies, facilitates carrying out their everyday medical duties in the hospital, makes their attendance at staff meetings easier, and serves to increase their participation in the hospital's medical education and research programs. While these leasing arrangements are also a convenience to the lessees, many of the benefits are passed on to the hospital and its patients in the form of greater efficiency and better overall medical care.

A charitable organization exempt under section 501(c)(3) of the Code is subject to the unrelated business income tax imposed by section 511 on income received from business leases. See sections 512(b)(4), 514(a)(1), and 514(a)(2) of the Code. The term "business lease" is defined in section 514(b) of the Code as a lease of real property for a term of more than five years if at the close of the lessor's taxable year there is a business lease indebtedness, as defined in section 514(c) with respect to such property. However, section 514(b)(3)(A)(i) of the Code provides that no lease shall be considered a business lease if such lease is entered into primarily for purposes which are substantially related (aside from the need of such

organization for income or funds or the use it makes of the rents derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

The leasing of office space adjacent to the hospital to members of the medical staff under the circumstances described contributes importantly to the hospital functions by increasing the hospital's efficiency, encouraging fuller utilization of its facilities, and improving the overall quality of its patient care. By leasing only to doctors who have staff privileges, the hospital is leasing the premises on the basis of a criterion that furthers hospital functions. Benefits thus derived from these leases by the hospital and its patients indicate that such leases are entered into primarily for purposes that are substantially related to the performance of hospital functions. Based on the facts presented, it is held that the leases described above come within the provisions of section 514(b)(3)(A)(i) of the Code and are not business leases.

c. Current Issues - Hospital participation in financing and construction of Medical Office Buildings

Recent cases go beyond the situations described in these revenue rulings (that is, the leasing by an exempt hospital of an already-existing medical office building to a group of physicians), and typically involve the hospital participating in the financing and construction of a medical office building to be owned by a separate entity. These situations often raise issues of inurement and private benefit.

(1) Hospital financing of construction of a Medical Office Building

In one case an exempt hospital contracted with its staff doctors for the construction of a medical office building adjacent to the hospital. The land upon which the building was constructed was owned by the hospital and leased to the doctors at its fair market value. Construction of the building was paid for and supervised by the doctors; however, the hospital agreed to lend each doctor an amount not exceeding his or her proportionate cost of the construction at prevailing interest rates. The loans were evidenced by promissory notes and were secured. Upon completion of the construction, each doctor owned the portion of the building he or she occupied, with the hospital owning the common areas.

There are two aspects of this arrangement that might result in private benefit to the doctors, the financing of the construction of the building and the land lease. The facts of the case as discussed above indicated, however, that there was no private benefit resulting from either of these transactions. We concluded that the contractual relationship entered into between the hospital and its staff members did not cause the hospital to lose its exempt status under IRC 501(C)(3). Any personal benefit derived by the doctors from the use in their private practice of the medical office building, which was financed by the hospital's assets and located on the hospital's land was merely incidental to the hospital's receiving a reasonable rate of return for the use of its assets and the various intangible public benefits flowing from the proximity of the medical building to the hospital.

(2) Hospital participation in a partnership formed for the financing and construction of a Medical Office Building

The majority of recent cases differ from the case discussed above in that they involve the participation of the hospital in a partnership with private investors for the financing and construction of a medical office building. Our concern with this type of arrangement is that, by entering into a partnership agreement with private investors, the exempt hospital will take on an obligation to further the private financial interests of the private investors that would conflict with its being operated exclusively for charitable purposes.

We are also concerned with who bears the risk of loss. Generally, under the law of partnerships, partners share in any losses incurred by the partnership. While the partners may agree among themselves to share losses in particular proportions, third persons are not bound by the agreement and may seek recovery in full from any one or more of the partners. Thus, if an exempt hospital enters into a partnership with a for-profit entity, the partnership incurs losses, and the for-profit entity becomes insolvent, the exempt hospital would bear the entire loss. Each partner may also be liable for torts committed by other partners within the scope of the business. Also, if an exempt hospital is a general partner in a limited partnership with private investors as limited partners, the private investors are liable for losses only to the extent of their respective capital contributions.

a. IRC 501(c)(3) organization prohibited from becoming a general partner in a profit-making partnership with private individuals and nonexempt organizations

In the following private letter ruling we held that an IRC 501(c)(3) organization would jeopardize its exempt status by becoming a general partner in a limited partnership that was to build an apartment complex for low-income senior citizens.

LTR-7820058, February 17, 1978

This is in reply to your letter of August 3, 1977, requesting the following rulings concerning the proposed transactions described below:

1. Whether the proposed transfer of 90% of your stock to X will jeopardize your status as exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954?
2. Whether the proposed amendment to your Certificate of Incorporation described below will jeopardize your status as exempt from Federal income tax under section 501(c)(3)?
3. Whether the proposed transfer by you of an apartment complex to a limited partnership, and your participation in that partnership, will jeopardize your status as exempt from Federal income tax under section 501(c)(3)?
4. Whether certain fees and income you will receive in connection with your participation in the partnership will constitute unrelated trade or business income under sections 511-514 of the Code?

The information submitted indicates that you were incorporated in 1976 under the laws of the state of N. You have been recognized as exempt from Federal income tax under section 501(c)(3) of the Code. X was incorporated in 1968 under the laws of the state of N, and has been recognized as exempt from Federal income tax under section 501(c)(3) of the Code.

Both you and X have been engaged in the construction of housing in deteriorated, urban-renewal areas of the city of M. You are now in the process of building an apartment complex for low income senior citizens in M. The project is being financed through a mortgage from the State of N Housing Finance Agency. For the purpose of raising additional funds for this project, you have proposed to transfer the project to a limited partnership. The partnership will be organized under a law of the state of N providing for the establishment of limited-dividend nonprofit housing corporations and associations. Under this law, the rate of return on investment is limited to 8% per annum, on a cumulative basis. However, this limitation does not apply, on dissolution, to income realized from the sale of assets to the extent attributable to an increase in market value or to a reduction of the mortgage.

The proposed partnership will have three general partners and 35 limited partners. You will be the managing general partner and will have the primary responsibility for the day-to-day operations of the housing project. A, a real estate consultant, and a corporation controlled by A will be the other general partners. In any disputes concerning operating policy between the general partners, the N Housing Finance Agency will make the final decision.

Incident to this proposed transaction, you will transfer 90% of your stock to X, and you will amend your Certificate of Incorporation to provide for this transfer.

Section 501(c)(3) provides, in part, for the exemption from Federal income tax of organizations organized and operated exclusively for charitable purposes.

Income Tax Regulations 1.501(c)(3)-1(d)(1)(ii) provides, in part, that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest.

Section 511 of the Code imposes, in part, a tax on the unrelated business taxable income of organizations exempt from Federal income tax under section 501(c)(3).

The transfer of your stock to another organization recognized as exempt under section 501(c)(3) will not jeopardize your exempt status.

However, if you entered the proposed partnership, you would be a direct participant in an arrangement for sharing the net profits of an income producing venture with private individuals and organizations of a noncharitable nature. By agreeing to serve as the general partner of the proposed housing project, you would take on an obligation to further the private financial interests of the other partners. This would create a conflict of interest that is legally incompatible with you being operated exclusively for charitable purposes.

Accordingly, we make the following rulings:

1. The proposed transfer of 90% of your stock to X, and the proposed amendments to your Certificate of Incorporation providing for this transfer will not jeopardize your status as exempt from Federal income tax under section 501(c)(3) of the Code.
2. The transfer by you of the apartment complex to a limited partnership, and your participation in that partnership would jeopardize your status as exempt from Federal income tax under section 501(c)(3).

Since we have ruled that the proposed partnership arrangement would jeopardize your status under section 501(c)(3) we have not ruled on the question you raised concerning the applicability of the unrelated business income tax, under sections 511-514, to this transaction.

We are notifying your key District Director of this action.

b. Current IRS Position - Facts and Circumstances approach

Our current thinking in this area is that a partnership arrangement between an exempt organization and a commercial entity or private investors will not per se jeopardize exemption. Whenever such an arrangement is involved, all the facts and

circumstances should be carefully scrutinized to determine whether any real conflict exists between the charitable and for-profit purposes.

(i) Participation of an IRC 501(c)(3) organization in a Joint Venture with a For-profit corporation

In the following private letter ruling we held that a IRC 501(C)(3) organization's exempt status would not be jeopardized by its participation in a joint venture with a commercial entity. (A joint venture is a partnership formed for a single transaction or project.) We concluded in this ruling that the facts and circumstances indicated that the joint venture would involve no conflict between the interests of the IRC 501(C)(3) organization and the interests of the commercial entity.

LTR 7921018, February 22, 1979

We have considered your request for a ruling that certain proposed transactions will not subject your organization to the Unrelated Business Income Tax imposed by sections 511 through 515 of the Internal Revenue Code.

The information you have provided indicates that your organization was created by Act of Congress and has been recognized as exempt from Federal income tax under section 501(c)(3) of the Code. Your organization has been classified as not a private foundation under section 509(a). In keeping with a broad range of charitable purposes, and with legislative mandate, your organization carries on an extensive program of collecting and processing human blood and blood derivatives so to provide them free of charge to the public. Your organization has been given responsibility for meeting the blood needs of the people of the United States in times of peace and war. Your overall blood program includes the conduct of research in the uses of human blood and its components.

You have explained that the process by which human blood is separated into its component parts or "fractions" is generally known as "fractionation." Various fractions have been discovered by medical research to be effective in the treatment of particular conditions and diseases. One type of fraction, for example, is given to victims of shock; another is used to treat hepatitis. Thus, through the process of

fractionation, a single unit of human blood may be used to treat a number of patients with differing needs. As a part of its blood program, your organization supplies blood fractions as well as whole blood free of charge to persons in need.

Because your organization lacks the technology for certain fractionation processes, you indicate that it has been necessary in the past for it to rely on commercial laboratories to fractionate the blood it collects. You indicate that in the past this commercial fractionation arrangement has often been unsatisfactory and that the price your organization pays is necessarily higher than what your own cost would be if you did your own fractionating. You therefore initiated a Request for Proposals from commercial laboratories for a "joint venture" fractionation facility.

You have proposed to enter into an arrangement with a commercial laboratory for the purpose of acquiring a building site and constructing a fractionation facility on it. Each party would be a co-owner of the facility on a 50/50 basis. You then propose to form a joint undertaking with the commercial laboratory for the purpose of operating the fractionating facility and thus supply the blood fractions to the parties. Under the proposed agreement the commercial laboratory would share its technological know-how with your organization and would make its own personnel available to work with your employees in operating the facility. At your discretion your organization would be permitted to make any technology acquired from the commercial laboratory or during the operation of the facility freely available to the public. Both parties will share production capacity of the facility on a 50/50 basis. The facility will process separately the blood collected by each party and deliver the resulting blood fractions to the party that supplied the blood. The facility will not itself directly engage in the sale of the resulting blood fractions.

Your organization will use its blood fractions for exempt purposes; the commercial laboratory will deliver its blood fractions to its subsidiary, which supplied it with the raw blood; and that subsidiary will, in turn, sell the blood fractions in its ordinary commercial manner. Sufficient liability insurance will be carried by both the commercial laboratory and its subsidiary so that the exempt party will effectively be shielded from any third party liability.

Finally, after 10 years of operation, your organization will have the option of purchasing the commercial laboratory's interest in the facility at a price equal to the commercial laboratory's aggregate capital contributions less one half the accumulated straight line depreciation on the depreciable assets. The transfer of the commercial laboratory's interest would take place over a five year phase-out period.

The object of this arrangement is that your organization will become self-sufficient in its production of blood fractions and thus be able more effectively to carry out your blood program in furtherance of your charitable purposes.

Collaterally, you have requested and received a Business Review Letter from the Anti-trust Division of U.S. Department of Justice to the effect that the Department has no present intention of filing any type of proceeding or of undertaking any further investigation with respect to the proposed joint undertaking.

Section 511 of the Code imposes a tax on the "unrelated business taxable income" of organizations exempt under section 501(c)(3).

Section 513(a) defines "unrelated trade or business" as any trade or business, the conduct of which is not "substantially related" to the exercise of performance by the organization of the purpose or function constituting the basis for its exemption under section 501.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that for a trade or business to be substantially related for purposes of section 513, there must be a substantial causal relationship between the conduct of the trade or business and the accomplishment of exempt purposes.

On the basis of the agreement submitted and your representations with respect to the proposed operations of the joint undertaking, we conclude that there is no inherent conflict between the interests of your organization and those of the commercial laboratory. We therefore conclude that your participation in this joint

undertaking, as proposed, is not inconsistent with your exempt status under section 501(c)(3).

We further conclude that the arrangement, as proposed, will contribute importantly to your organization's purpose of providing a supply of blood and blood derivatives to the public by permitting you to fractionate blood more economically and efficiently. We therefore conclude that your participation in this joint undertaking, as proposed, is substantially related to your exempt purpose and will therefore not generate gross income from an unrelated trade or business.

Accordingly, we rule that participation by your organization in the joint transactions and operations, as you have proposed in your ruling request dated **** and in supplementary documents filed in connection with that ruling request, will not subject your organization to the tax on unrelated business income imposed by section 511 through 515 of the Internal Revenue Code.

We are providing your key District Director with a copy of this ruling and you should keep a copy in your permanent files.

The Tax Court has recently held that an IRC 501(c)(3) organization that acted as a general partner in a limited partnership, where the limited partners were two individuals and a for-profit corporation, did not jeopardize its exemption by entering into the partnership arrangement. Plumstead Theatre Society, Inc. v. Commissioner, 74 T.C. No. 97 (9-18-80). Although we do not necessarily agree with the result in this case, it does provide another example of the type of partnership arrangements entered into by exempt organizations.

(ii) IRC 501(c)(3) exempt status not jeopardized where a subsidiary of the IRC 501(c)(3) organization becomes a general partner in a profit-making partnership

In Private Letter Rulings 7820057 and 8013041 we held that, under the facts and circumstances of each case, a section 501(c)(3) organization did not jeopardize its exemption by acquiring or forming a subsidiary to act as a general partner in a limited partnership formed for the purpose of constructing an apartment complex for low-income senior citizens and a medical office building, respectively.

LTR 7820057, February 17, 1978

This is in reply to your letter of August 3, 1977, requesting the following rulings concerning the proposed transactions described below:

1. Whether the proposed transfer to you of 90% of the shares of stock of Y will jeopardize your status as exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954?
2. Whether the proposed amendment to your Certificate of Incorporation described below will jeopardize your status as exempt from Federal income tax under section 501(c)(3)?
3. Whether the proposed transfer of an apartment complex to a limited partnership by Y, and Y's participation in that partnership, will jeopardize your status as exempt from Federal income tax under section 501(c)(3)?
4. Whether the payment of dividends to you by Y will constitute unrelated trade or business under section 512 of the Code?

The information submitted indicates that you were incorporated in 1968 under the laws of the state of N. You have been recognized as exempt from Federal income tax under section 501(c)(3) of the Code. Y was incorporated in 1976 under the laws of the state of N, and has been recognized as exempt from Federal income tax under section 501(c)(3).

You and Y have been engaged in the construction of housing in deteriorated, urban-renewal areas of the city of M. Y is now in the process of building an apartment complex for low income senior citizens in M. The project is being financed through a mortgage from the state of N Housing Finance Agency. For the purpose of raising additional funds for this project, Y as proposed to transfer the project to a limited partnership. The partnership will be organized under a law of the state of N providing for the establishment of limited-dividend nonprofit housing corporations and associations. Under this law, the rate of return on investment is limited to 8% per annum, on a cumulative basis. However, this limitation does not apply, on

dissolution, to income realized from the sale of assets to the extent attributable to an increase in market value or to a reduction of the mortgage.

The proposed partnership will have three general partners and 35 limited partners. Y will be the managing general partner, and will have the primary responsibility for the day-to-day operations of the housing project. A, a real estate consultant, and a corporation controlled by A will be the other general partners. In any disputes over operating policy between the general partners, the N Housing Finance Agency will make the final decision.

Incident to this proposed transaction Y will transfer 90% of its stock to you, and you will amend your Certificate of Incorporation to specifically permit you to hold the stock of other nonprofit housing corporations.

Section 501(c)(3) provides, in part, for the exemption from Federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from Federal income tax under section 501(c)(3).

Section 512(a) provides that the term "unrelated business taxable income" means, with certain modifications, the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less allowable deductions. Section 512(b)(1) provides that in determining unrelated business taxable income there shall be excluded all dividends. Section 512(b)(13), which provides an exception to some of the modification rules of 512(b) in the case of controlled corporations, does not apply to the payment of dividends.

The ownership of either taxable or tax-exempt subsidiaries will not jeopardize the exemption of an organization that is organized and operated exclusively for charitable purposes.

Accordingly, we make the following rulings:

1. The transfer to you of 90% of the shares of stock of Y will not jeopardize your status as exempt from Federal income tax under section 501(c)(3).

2. The proposed amendment to your Certificate of Incorporation permitting you to hold stock in other non-profit housing corporations will not jeopardize your status as exempt from Federal income tax under section 501(c)(3).

3. The transfer of the apartment complex to a partnership by Y and Y's participation in that partnership will not jeopardize your status as exempt from Federal income tax under section 501(C)(3).

4. The payment of dividends to you by Y will not constitute unrelated trade or business taxable income under section 512 of the Code.

LTR 8013041, January 4, 1980

This is in response to your request for a determination as to whether the construction by a section 501(c)(3) hospital of a medical office building and the transfer of that facility to a partnership composed of hospital staff physicians and possibly a subsidiary of the hospital, acting as a general partner temporarily, will adversely affect the hospital's exempt status, or subject it to unrelated business income tax. Additionally, you requested a ruling on whether any dividends received from the hospital's subsidiary would be subject to tax under section 511, and whether the lease of the land underlying the building will endanger the hospital's status or subject it to tax under section 511.

The information submitted indicates that the hospital was incorporated in 1948 under the Nonprofit Corporation law and was recognized as exempt under section 501(c)(3) of the Code in 1963, and was determined to be a public charity within the meaning of sections 509(A)(1) and 170(b)(1)(A)(iii).

The hospital proposes to construct a doctor's office building on land owned by it which is adjacent to the hospital. The purpose of the building is to increase the hospital's efficiency through full utilization of its facilities and to improve the quality of patient care by attracting more physicians with needed specialties and retaining existing staff which might otherwise be successfully recruited by proprietary hospitals.

The construction costs will be met through third party loans and partially through the hospital's own funds, if full financing is not available from a commercial lender. If the hospital does lend money for these costs, the term of the loan would be for the minimum consistent with the prevailing practices in the commercial field and with competitive interest rates. Other safeguards regarding the hospital's investment, including a second deed of trust in favor of the hospital and the fact that each individual partner will be personally liable for a proportional sum of any obligations owned by the partnership upon the loan, would also be required thereby assuring adequate security and protection for it.

Upon completion of the building, the hospital will transfer its interest to a limited partnership to be comprised of the individual physicians who will occupy the building. All physicians participating in the partnership must be staff members of the hospital. The proceeds from the transfer will then be used to liquidate the hospital's construction loans.

Prior to the actual transfer of the building to the partnership, the developer or the hospital will actively solicit the participation of the doctors. The hospital will recover any expenses attributable to the formation and offering of partnership interests as a portion of the purchase price paid by the partnership for the medical office building.

Each partner in the venture will participate in the partnership on the basis of his pro rata capital contribution. The amount of the capital contribution is determined by the amount of space to be occupied by the partner in the building. All items of income, expense and capital will be distributed on the basis of the proportional share of the partnership held by the individual doctor.

If at the time of the transfer of the building to the limited partnership, all of the office space in the building has not been accounted for by physicians, the hospital proposes to have a subsidiary acquire all remaining partnership interests and act as a general partner in this endeavor. This subsidiary will be capitalized by the hospital through a transfer of whatever funds are necessary to permit the subsidiary to acquire the outstanding partnership interests. The hospital would own all of the stock of the subsidiary.

The subsidiary will participate in the partnership only in the event that binding commitments have not been secured from individuals to purchase all of the partnership interests prior to the sale of the building. As additional physicians commit themselves to purchase space in the building, however, the subsidiary's share of the partnership will diminish proportionately. Therefore, the subsidiary will participate in the partnership only to the extent necessary to complete the sale of the entire building to the partnership and will be phased out as additional doctors commit for shares of the partnership and space within the building.

The hospital will not be involved in the management of the building once construction is completed and the transfer to the partnership is effected. The subsidiary will not be involved in the building's management unless it participates for a time as a partner. If the subsidiary is a partner, it may participate as a partner in the management of the medical office building to the extent that the other partners so so; however, at present, it is anticipated that responsibility for management will be placed with a commercial management company.

The hospital will act merely as the catalyst for the construction of the facility and its ultimate use by physicians. It does desire to maintain ethical controls over the activities of the physician/partners and in furtherance of that objective, proposes to lease the underlying land to the partnership at a fair annual rental.

Section 501(c)(3) of the Internal Revenue Code provides, in part, for the exemption from Federal income tax of organizations organized and operated exclusively for charitable purposes.

Rev. Rul. 69-464, 1969-2 C.B. 132, holds that the leasing of office space in a building owned by and adjacent to a hospital to the members of its medical staff is in furtherance of the hospital's exempt purposes under the circumstances of the ruling. The revenue ruling further states that the hospital's efficiency is improved and the quality of its patient care enhanced by having doctors located nearby.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c).

Section 512 of the Code and Section 1.513-1(a) of the Internal Revenue Code Regulations define the term "unrelated business taxable income" to mean: (1) income from a trade or business; (2) which is regularly carried on; and (3) the conduct of which is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 512(b)(1) of the Code generally provides that all dividends, interest, and annuities are excluded from treatment as unrelated business taxable income.

Section 512(b)(3) of the Code generally provides that all rents from real property are excluded from treatment as unrelated business taxable income. Section 512(b)(5) of the Code excludes from unrelated business taxable income any gain or loss from the sale, exchange or other disposition of property other than--

- (1) Stock in trade or other property of a kind which would properly be includable in inventory if on hand at the close of the taxable year, or
- (2) Property held primarily for sale to customers in the ordinary course of the trade or business.

Section 512(b)(4) of the Code provides that rental income or gains from the sale or disposition of property that would otherwise be excludable from taxation under Section 512(b)(3) and (5) shall be taken into account as unrelated business income pursuant to Section 514(a)(1) if attributable to "debt-financed property."

Section 514(b)(1)(A) of the Code provides that the term "debt-financed property" does not include any property substantially all the use of which is substantially related to the exercise or performance by the organization of its charitable, educational or other purpose or function constituting the basis for its exemption.

Section 514(b)(3)(A)(i) of the Code provides that no lease shall be considered a business lease if such lease is entered into primarily for purposes which are substantially related to the exercise or performance by such organization of its charitable, educational or other purposes.

The construction of the medical office building by the hospital is substantially related to its exempt purposes. Rev. Rul. 69-464, cited above, and also Rev. Rul. 69-463, 1969-1 C.B. 131, both hold that a hospital's efficiency is improved and the quality of patient care is enhanced by having doctors located nearby; therefore, the construction by the hospital of the medical office building and the lease of the underlying land to the partnership are in furtherance of its

exempt purposes and consistent with its status under section 501(c)(3) of the Code.

The actual transfer of the building to the partnership will not subject the hospital to unrelated business tax under section 511. The definition of unrelated business taxable income as set forth above does not encompass the type of transaction here described. This activity is not a trade or business of the hospital, is not regularly carried on by it, and is substantially related to the hospital's performance of its exempt functions.

After the medical office building is transferred to the partnership that will own and operate it, the subsidiary will acquire the partnership interests that have yet to be acquired by individual physicians, if any. The hospital's participation in either a general or limited partnership under the circumstances described above will be limited to an indirect and passive role by virtue of its ownership of a taxable subsidiary that will actually acquire any remaining partnership interests.

Section 512(b)(1) provides, in part, that dividends are excluded from treatment as unrelated business income. Section 512(c) provides rules for the treatment of tax exempt organization's share of partnership income. This provision thus contemplates the participation by tax exempt organizations in charitable as well as commercial enterprises conducted by partnerships. After the transfer of the medical office building, the subsidiary will sell its partnership interests to individual physicians until full occupancy is achieved. Any net gain to the subsidiary will be transferred to the hospital as a dividend. The hospital would not be subject to tax on this dividend income because of the exemption provided in section 512(b)(1) of the Code.

The hospital will enter into a long term lease with the partnership for the land underlying the medical office building. Any rental income from leasing the land to the partnership will be excluded from unrelated business income under section 512(b)(3) of the Code.

(iii) Problems associated with hospital financing of Medical Office Buildings

We have had several recent cases involving hospital participation through a wholly-owned subsidiary in a limited partnership formed to construct and operate a medical office building where we have not issued favorable rulings. Most of the problems in these cases have involved hospital financing of the construction project. Examples include the provision of interest-free loans by the hospital to the partnership, and an agreement by a hospital to make loans to the partnership, at prevailing interest rates, equal to the partnership's net operating losses, with no limit on the amount the hospital could be required to loan the partnership. Other questionable transactions include the leasing of land by the hospital to the partnership at less than fair market value; an agreement by the hospital to purchase the mortgage loan from the bank financing the construction project if there is a default by the partnership; and an agreement by the hospital to lease from the partnership a percentage of the unsold units in the medical office building.

d. Conclusion

It should be stressed that the Service is still in the formative stages in developing a position regarding the various types of arrangements for hospital financing and construction of medical office buildings. Any cases involving these types of arrangements should be forwarded to the National Office.

3. Faculty Group Practice Organizations

The 1980 EOATRI contained a discussion of faculty group practice organizations (referred to in the 1980 EOATRI as faculty compensation plans; see page 79 of the 1980 EOATRI).

a. Definition

A faculty group practice organization is a membership organization composed of physicians that are on the faculty of a university medical school. The physician-members of the faculty group practice provide medical care to patients. The group practice organization bills the patients, collects the fees, and disburses the funds received in accordance with a plan agreed to by the medical school, the university, and the physician-members. Faculty group practice organizations apply for exemption under IRC 501(C)(3) on the basis that they are promoting health.

b. Recent Activity

We have lost two court cases involving the IRC 501(c)(3) status of faculty group practices: B.H.W. Anesthesia Foundation v. Commissioner, 72 T.C. 681 (1979) and University of Massachusetts Medical School Group Practice v. Commissioner, 74 T.C. No. 94 (9-16-80). There is one additional case in the Tax Court, University of Maryland Physicians, P.A. that has been briefed and argued. Another Tax Court case, Shock Trauma Associates, P.A., is being held in abeyance pending the decision in the University of Maryland case. We have recently conceded Brigham Anesthesia Associates, Inc. We have also received several applications for exemption under IRC 501(c)(3) from faculty group practices, and have ruled favorably on a number of them.

c. Current Service Position

As a result of this recent activity, we have been re-examining much of our thinking in the area. The organization and operation of each faculty group practice organization tends to be unique in certain respects. For this reason, we have not as yet developed definitive rules regarding the tax exempt status of these types of organizations. We have, however, developed a list of factors that we look at in determining whether a faculty group practice is entitled to IRC 501(c)(3) status.

d. Primary Concern

In determining whether a faculty group practice qualifies as a IRC 501(c)(3) organization, the Service is primarily concerned with the resemblance these types of organizations have to for-profit group medical practices. The Service has traditionally taken the position that an organization that is engaged in what amounts to the private practice of medicine in a nonprofit framework is not exempt under IRC 501(c)(3). The two lead cases in this area are Lorain Avenue Clinic v. Commissioner, 31 T.C. 141 (1958) and Fort Scott Clinic and Hospital Corp. v. Brodrick, 99 F. Supp. 515 (D. Kansas 1951).

If an undertaking is conducted for private profit, it is not charitable. This is true although the purposes are such that, if it were not conducted for private profit, it would be charitable. Thus... a hospital... which is privately owned and conducted for the financial benefit of the owner is not a charitable institution.

The question is not whether the institution may receive a profit, but what disposition is to be made of the profit, if any, which may be received. If the profits are to inure to the benefit of individuals, the

institution is not charitable. IV Scott on Trusts, Paragraph 375 (3d ed. 1967)

e. Factors

The Service looks at the following factors in determining whether a faculty group practice qualifies as an IRC 501(c)(3) organization or whether it is operated for the private benefit of the physician-members.

(1) Relationship between the Faculty Group Practice and the affiliated hospital and medical school

The relationship between these entities is largely determined by how the medical school (and in some measure the hospital of which it is a part) views the faculty members' patient care activities. For example, we have seen situations where the medical school views patient care and billing as a matter within the province of the doctors themselves. Obviously, clinical instruction at medical schools requires "live patients." However, these institutions compensate their faculty for teaching and research and makes no attempt to control what they regard as the private practice of medicine. (We have seen instances where the patient billing was handled by a for-profit professional association without any input from the related medical school for periods ranging up to 30 years. These cases often come to our attention where the for-profit organizations intend to convert to nonprofit status without any change in the relationship between the medical practice and the medical school.) We think that this kind of fact situation strongly indicates that the organization is formed for the private benefit of the doctors.

Contrast that with the situation where the medical school views the clinical activities of the group's members as inseparable from the group's teaching and research functions. In these circumstances, the medical schools (and often the affiliated hospitals) have a role in the management of the medical practice. Just what this role is differs greatly from plan to plan. It can be as circumscribed as setting compensation limits or as comprehensive as active involvement in the day-to-day management decisions of the organization. There are no firm criteria as to how much involvement is necessary to establish that the practice in question qualifies for exemption under section 501(c)(3). However, we think some measure of involvement is required.

(2) Control of Compensation

Often the focus of issues relating to the relationship between the faculty practice plan and the related institutions is the issue of control of compensation. The importance of control of compensation in this regard arises from the fact that this one means through which the member-physicians can retain de facto control of the organization. While there is no absolute bar to member-physician control of compensation, we think there is clear potential for abuse of this situation.

For example, suppose that the member-doctors of a faculty group practice elect the group's board of directors, with the majority of the board being composed of member-doctors. The amount of compensation paid to member-doctors is subject to approval by the Dean of the affiliated medical school; however, the Dean is primarily concerned with the teaching and research activities of the faculty group practice and not with the distribution of salary or other benefits. There is also clear evidence that many of the patients seen by the doctors and billed through the plan are not involved in either research or the teaching function. We think that in this situation there are serious questions as to whether the medical school really controls the organization.

Many organizations have eliminated this problem by establishing an independent compensation committee to control the amount of compensation paid to the member-doctors. In other cases, medical schools have established compensation schedules that apply to all faculty physicians (whether or not they are members of a particular practice plan). The Service has not drawn any adverse inferences from physician - control of most other aspects of the group practice, such as continuing professional education and the like.

(3) How are the Faculty Group Practice's Funds Utilized

In this regard, we are looking for some evidence that the faculty group practice is not merely a mechanism physician-members. In making this judgment we ask the following questions.

(a) How are doctors compensated?

The method of compensation indicating that a private rather than a public interest is being served is where there is a direct correlation between the compensation paid to an individual group member and the fees received by the group as a result of the clinical practice of that member. Further indication of a private interest being served is where a member-physician may earn bonuses that are keyed to the amount of patient care fees generated by that member. These kinds

of arrangements indicate that the primary purpose of the group practice is to bill and collect patient care fees for the benefit of the individual member-physicians.

Conversely, a compensation arrangement indicating that the group practice is not operating for the benefit of its members is an arrangement where the amount of compensation paid to an individual group member is based on something other than the amount of patient fees generated by that member. For example, compensation could be based on the member-physician's academic standing and rank on the medical school faculty, with a member holding the rank of full professor receiving greater compensation than one holding the rank of associate professor regardless of the amount of patient fees earned by each member. Similarly, the compensation arrangement could be based on activities other than practicing medicine, such as teaching and research. Thus, a member-physician engaged solely in teaching and research activities with no patient care activities would not be precluded from earning as much or more than another member who earns large amounts for the group patient care activities. The fact that member-physicians are subject to limitations established by the affiliated medical school as to the total amount of compensation they may earn also indicates that a public rather than a private purpose is being served, the theory being that this type of limitation prevents the member-physicians from engaging in patient care activities to such an extent that it detracts from their teaching and research duties.

There is no clear-cut standard that the Service uses in resolving the compensation issues. Evidence that compensation is based on something other than the number of patients treated tends to be evidence that the plan is not organized for the benefit of member-physicians.

(b) Whether there is a meaningful charitable program funded by the fees generated by the group practice activities

When there is a serious question as to whether the group practice is furthering exempt purposes of the related school or hospital, the Service will question whether there is a meaningful charitable program funded by the fees generated by the group practice activities. For example, in one case the group practice's income was used first for the member-physicians' expenses in earning their fees, for the member-physicians' salaries, and fringe benefits. Most of the remaining funds were expended for administrative expenses of the member-physicians who generated the funds. Only a very small portion of the group's income was expended for a purpose that could clearly be termed charitable (a medical school development fund). The amounts set aside for the development

fund did not correlate with the needs of the medical school but rather represented a fixed percentage of the plan's earnings year-in and year-out.

In contrast, in another case involving a faculty group practice, although a large portion of the group's income was expended for compensation of the member-doctors, considerable amounts were accumulated in a fund to be used in the future to expand the facilities of the hospital, improve the quality of patient care, and advance the medical training, educational, and research programs which the group practice conducts with the hospital and medical school. The amount of funds set aside was determined in consultation with the hospital and the medical school and responded to the needs of these two institutions.

(c) Are there any other activities that indicate the faculty group practice serves a public rather than a private purpose?

The Service will look for other factors indicating that the faculty group practice is serving a public interest. One factor that the Service views as relevant in this regard is whether the group practice has a policy of providing free medical services to persons unable to pay. There is no absolute free care requirement, however, but this in combination with other factors may indicate that the group practice is benefitting the public.

In summary, in determining whether a faculty group practice qualifies as a tax exempt organization, the Service is primarily concerned with the resemblance these organizations have to for-profit group medical practices. We have discussed the aspects of faculty group practices that are of particular concern to the Service. We should take a facts and circumstances approach, with particular emphasis on these factors, to determine whether a faculty group practice is entitled to exempt status. It should be emphasized that we are still in the formative stages of developing a position with respect to faculty group practices. Consideration should be given to forwarding these types of cases to the National Office.

4. Home Health Agencies

(a) Definition

Home health agencies are defined in the Social Security Act as organizations primarily engaged in providing skilled nursing services and other therapeutic services to patients in their homes. To be a qualified home health agency under the Social Security Act, the agency must either be exempt under IRC 501 or be

licensed pursuant to state law. In Revenue Ruling 72-209, 1972-1 C.B. 148, the Service held that qualified home health agencies are exempt under IRC 501(c)(3).

(b) GAO's interest

Home health agencies are the subject to an ongoing study by the General Accounting Office. GAO's interest in home health agencies stems from allegations that medicare and medicaid funds have been siphoned off into the hands of for-profit organizations and that this is one reason the cost of these programs is so high. Because of the interest in this area, we included in the 1981 program letter to our field offices a requirement to examine ten percent of them.

(c) Partnership with For-profit organizations

In May 1979 the General Accounting Office issued a report highlighting several abuse situations found to exist in the home health care area. These situations are discussed in detail in the 1980 EOATRI at pages 75-77. One of the issues raised was the establishment of home health agencies by for-profit organizations under agreements that resemble commercial franchise arrangements. A typical contract requires that the home health agency pay a large initial fee plus a monthly fee based on a percentage of the agency's gross billings in return for assistance in establishing and operating the agency.

The agency is also required to purchase manuals and various business forms from the for-profit organization. The contract provides that if the home health agency fails to meet certain operational levels, the for-profit organization has the right to substitute management or purchase sufficient voting stock to elect a majority of the agency's board of directors. The for-profit organization also has the right to examine the agency's books, and the agency is prohibited from establishing another health agency within 50 miles of its location should the agreement be terminated. The term of the contract is 35 years.

We think that under the terms of the contract, in particular that part of the contract giving the for-profit organization the right to manage the agency or buy voting stock in the event that certain production levels are not met, the home health agency is taking on an obligation to further the private financial interests of the for-profit organization.

Where a home health agency has entered into a partnership or joint venture with a for-profit organization, we should carefully scrutinize not only the specific

contract provisions but all the facts and circumstances to determine whether a conflict exists between the charitable and for-profit purposes. We issued revised examination guidelines in March 1980 to address these problems. We are now in the process of revising these guidelines to provide further examination guidelines on management and consultant contracts between exempt home health agencies and for-profit consulting firms.

5. Professional Standards Review Organizations (PSROs)

(a) Definition

The PSRO program was established by Congress in 1972 to ensure the efficient delivery of health care services to medicare and medicaid beneficiaries. PSROs review the professional activities of physicians and other health care professionals and recommend the imposition of sanctions against practitioners who violate their obligations under the Social Security Act. The law also provides PSROs with a number of other functions and responsibilities, including the development of regional norms and criteria of diagnosis and care in order to foster the reduction of unnecessary medical care.

(b) Prior IRS Position

The Service position in the past was that PSROs were not exempt under IRC 501(c)(3) because, although they may provide some public benefit, they also serve a business interest by maintaining the professional standards, prestige, and independence of the medical profession. Our position was that PSROs were more appropriately classified as section 501(c)(6) business leagues.

(c) Court Cases

We have since lost two IRC 501(c)(3) declaratory judgment cases involving PSROs: Virginia Professional Standards Review Foundation v. Blumenthal, 466 F. Supp. 1164 (D.D.C. 1979), and PSRO of Queen's County, Inc. v. Commissioner, 74 T.C. No. 18 (5-8-80). The courts in these cases reached similar conclusions, stressing the legislative history of the PSRO program and that PSROs' activities were of a quasi-governmental nature and had been specifically mandated by Congress. Both courts dismissed any private benefit accruing to members of the medical professions as being merely incidental to the PSRO's charitable activities.

(d) Current IRS Position

We have been reviewing our position and have concluded that PSRO's serve functions that lessen the burdens of government and promote health, and that any benefits derived by members of the medical profession from PSRO activities are incidental and do not preclude exemption under IRC 501(c)(3). Therefore, a PSRO may qualify for exemption under IRC 501(c)(3), and we are no longer suspending these types of cases. However, one issue not addressed in the litigation is the characterization of payments received from medicare/medicaid for purposes of the foundation provisions. We have concluded that payments received from medicare/medicaid should be characterized as "support from a governmental unit" rather than "amounts received from an organization's exercise or performance of its exempt purpose or function." (If the payments are characterized as gross receipts, Reg. 1.170A-9(e)(7)(i)(a) will preclude PSROs from satisfying the support requirements of IRC 170(b)(1)(A)(vi). However, if the payments are characterized as grants, and therefore "support from a governmental unit," Paragraph 1.170A-9(e)(8)(i) will assure that PSROs satisfy the support requirements of IRC 170(b)(1)(A)(vi).) Therefore, a PSRO receiving all of its support from medicare/medicaid payments will be treated as a publicly supported organization under IRC 170(B)(1)(A)(vi), and not a private foundation.

(e) Unresolved Issue

We are still considering the issue of whether peer review activities performed by a PSRO for for-profit insurance companies constitutes an unrelated trade or business.

6. Cooperative Hospital Service Organizations

(a) Recent Court Decisions

Discussed at pp. 77-79 of the 1980 EOATRI. During the past year, we have won four cases involving the IRC 501(c)(3) status of cooperative hospital laundries. (Hospital Central Services Association v. U.S., 80-2 U.S.T.C. Paragraph 9570 (9th Cir. 1980), HCSC-Laundry v. U.S., 80-2 U.S.T.C. Paragraph 9483 (3d Cir. 1980), Metropolitan Detroit Area Hospital Services, Inc. v. U.S., Nos. 78-1205 and 78-1218 (6th Cir., filed Nov. 4, 1980), and Associated Hospital Services, Inc. v. Commissioner, 74 T.C. No. 17 (5-6-80).) HCSC-Laundry has filed a petition for a writ of certiorari, seeking Supreme Court review of the appeals court's decision, and the Service is in favor of the Supreme Court resolving the conflicting court decisions in this area. Associated Hospital Services is appealing the Tax Court's

decision to the 5th Circuit Court of Appeals. There are also several other cases involving cooperative hospital service organizations pending at the trial level and the appellate level. The National Office has also issued several ruling letters in this area during 1980.

Because of this activity, we are updating the 1980 EOATRI article and reiterating our position with respect to these types of organizations.

(b) Definition and IRS Position

Cooperative hospital service organizations are owned and operated by their member-hospitals to provide services to those hospitals. The hospitals pool their resources to form the cooperative and pay the cooperative a fee designed to cover the cooperative's costs. It is the Service's position that cooperative hospital service organizations are feeder organizations under IRC 501 and therefore not exempt under IRC 501(c)(3) unless they are specified in IRC 501(e) or unless the cooperative is providing noncommercial purposes, such as health care or education and research.

(c) Explanation of IRC 501(e)

Under IRC 501(e), an organization is treated as an IRC 501(c)(3) charity if it is organized and operated solely to perform, on a cooperative basis, one or more of the services enumerated in IRC 501(e) (data processing, purchasing, warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel services (including selection, testing training and education of personnel)). IRC 501(e) also places other restrictions on cooperative hospital service organizations. The enumerated services must be performed solely for two or more hospitals, each of which is either exempt under IRC 501(c)(3), or part of a larger complex like a university hospital, or owned and operated by certain governmental entities. The cooperative organization must also be organized and operated on a cooperative basis and allocate or pay, within 8 1/2 months after the close of its taxable year, all net earnings to its patrons on the basis of services performed for them. Capital Stock (if any) must be owned by the patrons.

(d) Situations where exemption is sought under IRC 501(c)(3) instead of IRC 501(e)

IRC 501(e) parallels the rules applicable to other cooperatives and problems arise where these types of organizations seek exemption directly under IRC 501(c)(3) rather than IRC 501(e). There are, however, several reasons why hospital cooperatives choose to do so.

One situation where a cooperative hospital service organization would seek exemption under IRC 501(c)(3) rather than IRC 501(e) is where the services provided by the cooperative organizations to its members are not listed in IRC 501(e). The best-known example of this situation has been litigated in the series of court cases involving cooperative hospital laundries. As stated above, we have won four recent cases involving this issue. We have several other similar cases pending in the courts involving laundry services and other services not specified in section 501(e). We intend to proceed with these cases, especially in light of the recent court decisions in our favor.

Another situation where a cooperative hospital service organization would seek exemption under IRC 501(c)(3) rather than IRC 501(e) is where the organization either cannot or chooses not to meet the requirements of IRC 501(e), even though the services provided by the organization are listed in IRC 501(e). For example, a cooperative organization may not be able to meet the requirements of IRC 501(e) because it wants to have members that are not tax-exempt hospitals (such as proprietary hospitals or tax-exempt educational organizations), or it may wish to provide services to organizations other than its members and not pay them patronage. Neither of these situations would be permissible under IRC 501(e). Also, an organization that meets the IRC 501(e) requirements may nevertheless want exemption directly under IRC 501(c)(3), either to avoid IRC 501(e) restrictions or for state tax purposes. An example of the latter situation is a case involving an IRC 501(e) organization that wanted exemption directly under IRC 501(c)(3) because, under state law, IRC 501(c)(3) organizations were exempt from state sales tax, while IRC 501(e) organizations were not so exempt.

An example of a cooperative hospital service organization avoiding the restrictions of IRC 501(e) by applying for exemption directly under IRC 501(c)(3) is Chart, Inc. v. U.S., 79-2 U.S.T.C. Paragraph 9735 (D.D.C. 1979). In that case, a cooperative data processing organization that qualified for exemption under section 501(e) sought exemption under section 501(c)(3), apparently for more flexibility. For example, if the organization were to expand into the nursing home field it would be disqualified under IRC 501(e). Similarly, IRC 501(e) requires that the organization distribute its net earnings to its members within 8 1/2 months of the close of each taxable year, while IRC 501(c)(3) does not explicitly impose such a

requirement. The district court for D.C. followed the earlier laundry court decisions and held the organization exempt under IRC 501(c)(3). [The court noted that its interpretation would "render section 501(e) essentially meaningless."] We are appealing this decision.

(e) Issues currently under consideration

The volume of recent cases and ruling requests indicates that hospital cooperatives are widespread. The following are examples of issues considered by the Service during the past year, indicating the variety of issues in this area.

- (1) Whether an organization that provides educational, group purchasing, collection, management, clinical, engineering, and building and construction services to subscribers and nonsubscribers is exempt under IRC 501(c)(3).
- (2) Whether a cooperative hospital purchasing organization qualifies for exemption under IRC 501(c)(3).
- (3) Whether an IRC 501(e) organization can own and operate a for-profit corporation that provides IRC 501(e) services to organizations not described in IRC section 170(b)(1)(A)(iii).
- (4) Whether a cooperative hospital insurance organization is exempt under IRC 501(c)(3).
- (5) Whether the existence of non-hospital members will cause an IRC 501(e) organization to lose its exemption.
- (6) Whether a cooperative hospital service organization that provides the following services under IRC 501(c)(3): community health services, legal services, financial services, computer services, dietary training, social work training, professional recruiting, public relations, pathology and radiology services, emergency room, employee assistance, community health and educational program, material management assistance, trustee, education, continuing professional education, infection control, physical and respiratory therapy, and nuclear medicine.

- (7) Whether a cooperative hospital organization that provides heating and cooling services to its members qualifies for exemption under IRC 501(c)(3).
- (8) Whether an organization that provides laundry services and computer rental services to its member-hospitals on a cooperative basis should continue to be recognized as exempt under IRC 501(c)(3). In an effort to contain costs, hospitals will most likely continue to set up these types of cooperative service organizations.

7. Shared Services

(a) Definition, Current Issues, and General Rules

The term "shared services" refers to the provision of services by a tax-exempt hospital to other tax-exempt hospitals, organizations (both for-profit and nonprofit), and individuals. The two issues raised by this activity are (1) whether the exempt status of the IRC 501(c)(3) hospital providing the service will be jeopardized, and (2) whether the hospital providing the services will be subject to the unrelated business income tax.

This topic is discussed in the 1980 EOATRI at pp. 80-81. Under IRC 513(e), a tax-exempt hospital may provide the services specified in IRC 501(e) (including laboratory services, discussed below) in certain limited situations to other tax-exempt hospitals without being subject to tax. The Service is currently considering the issue of which shared service arrangements, other than those described in IRC 513(e), do not give rise to unrelated business income tax.

Generally, an exempt hospital may provide services to other organizations and to individuals without being subject to the unrelated business tax if the services provided further an exempt purpose, which in this context is usually the promotion of health, or if the volunteer labor, convenience, or donated merchandise exception under IRC 513(a) apply.

(b) Examples of shared service arrangements

The following recent technical advice memoranda deal with the unrelated business income tax liability of various types of shared service arrangements.

Although these rulings have no value as precedent, they do provide examples of the kind of analysis involved in these determinations.

(1) LTR 8004011 (No date)

Issue:

Whether the activities of rendering EKG service to other hospitals constitute unrelated trade or business under section 513 of the Internal Revenue Code of 1954.

Facts:

The organization was granted exemption from federal income tax under section 501(c)(3) of the Code on October 15, 1971. The organization has for its purpose the overall objective of improving and promoting the medical and health care in the community and its adjoining areas. In furtherance of its purpose, the organization operates an out-patient clinic including diagnostic and surgery services for its patients not requiring hospitalization. It is also involved in several charitable programs which include medical aids to indigent, elderly, well-child care for parents who are financially unable and other medical assistance referred by hospitals, health centers, social welfare and other charitable organizations. The foundation's support consists of clinic's fees, contributions, interest income and EKG service fees. The latter service is for reading and diagnostic EKG tests for a local hospital who does not have the qualified physician and facilities to provide such services. The District Office concluded that this activity by the organization is unrelated trade or business. The organization dissents the conclusion and requested consideration from the National Office.

Applicable Law:

Section 513 of the Code defines the term "unrelated trade or business in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for

income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt purposes.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes. For the conduct of trade or business from which a particular amount of gross income is substantially related to purposes for which exemption is granted, the performance of services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Rationale:

The organization by allowing its specialized physicians and its facilities to be used in reading and diagnosing EKG tests for the hospital who do not have the qualified physicians and facilities to render such service, is engaged in the activity of promoting the general health of the community. The activities contribute importantly to the accomplishment of the purpose for which the organization was granted exemption under section 501(c)(3).

Conclusion:

We, therefore, conclude that the activities of the organization of rendering EKG service to a hospital do not constitute unrelated trade or business under section 513 of the Code.

(2) LTR 8013052 (no date)

Issue:

Are services providing orthotic fittings and devices to patients, and services providing physical therapy for patients, provided by a

hospital exempt from income taxation under section 501(c)(3), unrelated trade or business when provided to other than the hospital's own patients?

Facts:

The organization was created on *** for the purpose of aiding the crippled, handicapped, and afflicted, operating a hospital and rehabilitation center, and doing other charitable work. The organization operates an eighty bed rehabilitation hospital; it also operates an orthotic device facility and two physical therapy facilities each located within other unrelated tax exempt hospitals in the community. For the taxable years at issue here, 86% of the patients referred to the orthotic service facility were patients of private physicians who were also on the staff of the organization. These patients otherwise had no connection with the organization. There were no other orthotic services commercially available in the locality.

At the two physical therapy facilities, the organization handles medical records and billings for outpatients using the therapy services at one hospital, but does not handle such records and billings at the other. It does not handle records and billings for inpatients using physical therapy services at either of the other hospitals. It provides the staff for both facilities. The organization receives as consideration from these hospitals the gross billings from these patients less a facilities charge and other costs.

Tax exemption under the predecessor of section 501(c)(3) was granted on ***. Because it is a hospital described in section 170(b)(1)(A)(iii), the organization qualifies for non-private foundation status, and accordingly, it was determined not to be a private foundation on ***.

The District Director concluded that because services were provided to patients who were not themselves patients of the hospital, income from orthotic device and physical therapy services constituted taxable unrelated business income to the hospital. From this conclusion, the organization appealed to the Appeals Division. Both the Appeals Division and the organization request technical advice from this office.

Applicable Law:

Section 513(a) of the Internal Revenue Code provides, in part:

The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose of function constituting the basis for its exemption under section 501.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is related to the exempt purpose of any organization where the conduct of the business activities has a substantial causal relationship to the exempt purpose. Where the production of goods or performance of services from which the income is derived contributes importantly to the accomplishment of the exempt purposes, the activities will be considered substantially related to those purposes.

Section 513(e) of the Code refers to services provided by a hospital to one or more other hospitals and sets forth the circumstances under which services described in section 501(e)(1)(A) will not be considered "unrelated trade or business."

Rationale:

A tax-exempt hospital specializing in rehabilitation of the crippled and handicapped serves its charitable purpose by providing health care and medical attention to individuals needing its specialized services. Physical therapy treatment to patients is one of many types

of medical care that such a hospital might provide for them. Likewise, the designing and fitting of braces and other orthotic devices by a skilled orthotist is a type of medical care to specific individuals that is well within the scope of the charitable activities of the hospital. Both services contribute importantly to the hospital's exempt purposes and are therefore substantially related to the exercise of the hospital's exempt function. Where activities are substantially related to the exercise of a hospital's exempt function, it is irrelevant whether the benefitted individuals are administratively deemed patients of a particular hospital or of no hospital.

Revenue Rulings 68-374, 1968-1 C.B. 242; 68-375, 1968-1 C.B. 245; and 68-376, 1968-1 C.B. 246, all deal specifically with the issue of hospital pharmacy sales to the patients of private physicians, to the hospital's patients, and to the general public. The services offered by a pharmacy are not of the specialized nature of either orthotic fitting services or of physical therapy services. There is little that a pharmacy does requiring the specific treatment and specialized patient care involved in either of the activities in question here. The function of a hospital pharmacy is to sell and dispense drugs and is, in essence, identical to the function of commercial pharmacies with which it would directly compete if open to the general public. The Revenue Rulings listed above set forth rules to define the term "patient" in order to differentiate those pharmaceutical services of a hospital that are patient-related from those activities indistinguishable from those of a commercial pharmacy. A major purpose of the distinction is to eliminate any aspect of unfair competition between a tax-exempt hospital pharmacy and a taxable commercial pharmacy. Orthotic and physical therapy services, on the other hand, are provided by physicians and specialists directly to their patients. They are of a type central to the specialized patient care of a rehabilitation hospital and contribute importantly to the charitable activities of such a hospital. There is little, if any, competition with outside mercantile and commercial interests. Such services are substantially related to the exempt function of a hospital.

Section 513(e) of the Code, which sets forth circumstances when services provided by one hospital to other hospitals represent sources of tax-exempt income, is not relevant where charitable

services constituting the basis for the hospital's tax-exemption are, as here, provided directly to patients.

Conclusion:

The organization is not subject to the tax on unrelated trade or business under section 511 of the Code with respect to its orthotic services and physical therapy services located within the physical facilities of other tax-exempt hospitals, where those services are provided directly to individuals in need of those services.

(3) LTR 8016010, January 16, 1980

Issue:

Does the clinical testing of a drug, the results of which will be used by a commercial sponsor in the ordinary course of its commercial operations, constitute an unrelated trade or business to a hospital exempt under section 501(c)(3) of the Internal Revenue Code?

Facts:

X is a hospital exempt from tax under section 501(c)(3) of the Code. The hospital has a large pulmonary clinic and has an extensive allergy clinic service.

Y is a division of a commercial corporation engaged in the development of pharmaceuticals for profit.

X and Y entered into a written agreement whereby X agreed to conduct a clinical test on some of its patients of the safety and efficacy of an experimental drug to be used in the treatment of asthma. The hospital has not indicated if patient participation was limited to those who were unable to benefit from existing asthma treatment, nor has the hospital established that its participation in the testing program was directly related to actual patient care.

Experimental method and procedure were largely designed by Y. The information submitted indicates that Y intended to use the results of the study incident to its normal commercial operation of requesting F.D.A. approval of the drug.

Applicable Law:

Section 511 of the Code imposes a tax upon the unrelated business taxable income of organizations exempt under certain sections including section 501(c)(3) of the Code.

Section 513 of the Code defines the term "unrelated trade or business" as any trade or business, the conduct of which is not substantially related to the exercise or performance by an exempt organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 1.512(a)-1 of the Income Tax Regulations provides that except as otherwise provided, unrelated business taxable income is defined as the gross income derived from any unrelated trade or business regularly carried on.

Section 1.513-1(d)(1) of the Regulations provides that gross income derives from "unrelated trade or business" if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question and the accomplishment of the organization's exempt purpose.

Section 1.512(b)-1(f)(2) of the Regulations provides that in the case of a college, university, or hospital, all income derived from research performed for any person and all deductions directly connected with such income, shall be excluded in computing unrelated business taxable income.

Section 1.512(b)-1(f)(4) of the Regulations provides that for the purpose of section 1.512(a)-1, section 1.512(a)-2, and this section, the term "research" does not include activities of a type ordinarily carried

on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc.

Revenue Ruling 68-373, 1968-2 C.B. 206 holds that the clinical testing of drugs for commercial pharmaceutical companies is an activity ordinarily carried on as an incident to the company's commercial operations, and therefore is not scientific research.

Revenue Ruling 76-296, 1976-2 C.B. 141, provides, in part, that an activity which otherwise qualifies as scientific research will not constitute unrelated trade or business by reason of its being undertaken pursuant to contracts with private industry.

Rationale:

The clinical tests were performed according to a protocol designed by Y. Y intended to submit the results of the tests to the F.D.A. in order to meet F.D.A. requirements for approval to market the drug. The testing of this drug was required as part of the ordinary process of obtaining approval of the drug prior to marketing. It was of a type ordinarily carried on as an incident to Y's commercial operations, and is not scientific research within the meaning of the Regulations. Revenue Ruling 76-296 is not applicable as that ruling did not discuss what constitutes scientific research, but rather presented a situation in which an organization had already established that it performed such research.

Although the testing of this drug does not constitute scientific research, it might be possible for X to establish that the activity furthered X's exempt purpose of patient care. However, X has not established that its participation in the testing program was directly related to patient care, or otherwise furthered its exempt purposes.

Conclusion:

The clinical testing of this experimental drug was incident to Y's ordinary commercial operations, and therefore did not constitute scientific research. Absent a showing that the testing furthers an

exempt purpose of X, the testing constitutes an unrelated trade or business.

(c) Court Cases

There are also two relatively recent court cases involving the unrelated business income tax liability of hospital shared service arrangements, Carle Foundation v. United States, 79-2 U.S.T.C. 9727 (7th Cir. 1979) and St. Luke's Hospital of Kansas City v. United States, 80-2 U.S.T.C. 9533 (W.D. Mo. 1980).

(1) Carle Foundation v. U.S.

In Carle Foundation a tax-exempt hospital worked in a close inter-relationship with a for-profit medical clinic composed of physicians on the hospital's medical staff. The hospital's pharmacy sold pharmaceutical supplies to the clinic and the clinic's patients. The seventh circuit held that the sales constituted an unrelated trade or business on two grounds. First, the court held that these sales were not made primarily for the convenience of the hospital's patients. In reaching this conclusion, the court analyzed Rev. Rul. 68-376, 1968-2 C.B. 246, which gives examples of "patients" within the meaning of section 513. The court reasoned that since the hospital and the clinic were separate legal entities, patients of the clinic were not patients of the hospital. Also, the mere fact that the clinic performed outpatient testing services for hospital patients did not transform the clinic's private patients who were receiving the same type of services into "hospital patients." Second, the court held that the pharmaceutical sales were not related to the hospital's exempt function. In reaching this conclusion the court attached significance to the fact that the hospital pharmacy was in direct competition with its nonexempt counterparts, and that the hospital had derived substantial profits from these sales, indicating a business rather than an exempt purpose.

(2) St. Luke's Hospital of Kansas City v. U.S.

The other case, St. Lukes, involved a somewhat different approach to the unrelated trade or business issue. In that case a tax exempt hospital operated a pathology laboratory in which tests were made on specimens obtained from patients of St. Luke's staff physicians in the course of their private practices. St. Luke's filed unrelated business income tax returns. (Form 990-T), reporting as unrelated taxable income the income derived from the pathology tests made for the

staff physicians' private patients. After refund claims were filed and disallowed, St. Luke's brought suit for a refund.

St. Luke's made the usual argument that providing these types of services is not an unrelated trade or business because it is substantially related to the hospital's exempt purpose of promoting health. However, this case is different in that St. Luke's also argued that these "outside pathology tests" were not an unrelated trade or business because they contributed importantly to its medical education program.

The court did not respond at all to St. Luke's argument that the outside pathology tests were substantially related to the promotion of health. The court did hold, however, that these tests were substantially related to St. Luke's educational function and as such were not unrelated trade or business. In reaching this conclusion, the court reasoned that by increasing the number of abnormal test result slides for physicians, interns, and residents to study and interpret, the outside pathology tests enriched the available instructional material, thereby improving the teaching program.

Factually, the case was not developed at the administrative level to deal with the issue of whether the outside pathology tests contributed importantly to the hospital's educational program, because that argument was not spelled out in St. Luke's initial claim for refund. This entered into our decision not to appeal the case.

In addition to the "substantially related" arguments, St. Luke's argued that the "convenience exception" applied to except the outside pathology tests from the unrelated trade or business tax. St. Luke's argued that the tests were performed for the convenience of the physicians on its medical staff, who, St. Luke's argued, were "members" for purposes of the convenience exception. St. Luke's also argued alternatively that the tests were performed for the convenience of its patients.

The court did not respond to the latter argument. The court concluded, however, that the performance of the outside pathology tests was primarily for the convenience of physicians on St. Luke's medical staff, who the court concluded were "members" of the hospital for purposes of the convenience exception.

We believe that this conclusion is wrong because for purposes of the convenience exception, the physicians of the hospital's medical staff should not be considered as members of the hospital. Even if it is conceded for the sake of argument that staff physicians are "members" of the hospital, we do not accept the

court's conclusion that these tests were performed "primarily for the convenience" of these individuals, as required by IRC 513. In order to satisfy this requirement, St. Luke's must establish that its primary objective in conducting these outside pathology tests was for the convenience of its staff physicians. Given the large amount of revenue produced by these tests and the court's previous conclusion that the tests contributed importantly to the hospital's educational function, we believe that the court erred in concluding that these tests were performed by the hospital primarily for the convenience of these physicians.

(d) Laboratory Services

The issue of whether the provision of laboratory services by a tax exempt hospital to other organizations and to individual physicians constitutes unrelated trade or business is still pending in the National Office. Technical advice should continue to be requested in these types of cases.